

Over the last six weeks, there have been an increasing number of declarations of *force majeure* in the global LNG market reported, both under (i) single source/single train SPAs with Middle Eastern sellers, such as QatarEnergy, following missile attacks at the Ras Laffan facilities; (ii) portfolio agreements from portfolio LNG sellers with offtake capacity or supply arrangements in the Middle East; and (iii) short-term or trading transactions.

In our previous articles, we highlighted the importance of carefully scrutinising the contents of a *force majeure* notice to ascertain its validity and compliance with the relevant agreement and verifiable facts. In this article, we delve deeper into the two questions provoking much debate in the market right now:

- What is the scope and extent of the duty to mitigate?
- What are legal and commercial options for traders in managing the supply shortfalls on the trading desk?

We address each in turn.

## The Duty To Mitigate

At the outset, it bears repeating that *force majeure* is a creature of contract and, therefore, the exact scope of the parties' rights and obligations will depend on the specific wording of the *force majeure* provision, interpreted in accordance with the applicable governing law. The following discussion is therefore cast in general terms.

A party claiming *force majeure* may be required to comply with an endeavours obligation – be it “reasonable”, “all reasonable”, “best” or otherwise – to (i) resume normal performance; (ii) bring the event to an end (often acting as a “reasonable and prudent operator”); and (iii) mitigate the effects of the *force majeure*. In an LNG context, this raises questions as to the extent of the mitigation duty and whether a seller claiming *force majeure* must procure replacement supplies in order to comply with its duty to mitigate the *force majeure*.

Ultimately, whether a seller must procure replacement supplies – for example, in the spot or short-term market, or from its wider portfolio – depends on a number of factors.

The primary consideration is the wording of the agreement and the applicable governing law to determine the legal meaning of the duty. For example, it is common to see a “reasonable endeavours” obligation attached to the duty to mitigate in *force majeure* provisions. This obligation imports a standard under English law requiring that a party pursue a reasonable course of action, and one which does not require it to subvert its own commercial interests in satisfying the duty. This is a lesser threshold than, for example, “best endeavours”, which, depending on the context, may instruct the claiming party to use its best efforts to satisfy the obligation and may require some sacrifice of its own commercial interests.

Against that backdrop, courts and tribunals typically assess mitigation efforts by examining the steps and actions being taken by the party claiming *force majeure* across a variety of measures, in an effort to determine when those measures become commercially disproportionate to the duty.

An important consideration may be whether the particular agreement is for supply from a single source or LNG train, or a portfolio arrangement, whereby the seller is entitled to supply LNG to the buyer from a variety of sources listed in the relevant agreement, provided it meets the quality specifications. Based on which contractual framework applies, there may be important differences in the scope and effect of the duty to mitigate and whether an obligation exists to replace the shortfall volumes.

In a single supply source/single train contract, if the named facility/train goes offline or otherwise becomes unavailable for reasons that are outside of the control of the party claiming *force majeure* relief, a seller's mitigation efforts may involve, for example:

- Evaluating the cause and scale of the issue and the potential impact on its performance
- Promptly undertaking an appraisal of the repairs required, seeking replacement parts (as applicable) and developing a remedial timeline for the works
- Mobilising alternative systems, where feasible
- Performing safe and potentially temporary fixes to allow for partial operations to resume, if possible
- Assessing and allocating any available supplies among its buyer pool on an equitable basis

In a portfolio arrangement, a seller may find it more challenging to claim *force majeure* in circumstances where, for example, the *force majeure* event impacts only one supply source, leaving other contractually nominated load ports within its portfolio available.

However, there are still a number of other considerations. For example, in contracts which provide for both (i) a particular supply source(s), but also (ii) the seller having the ability to supply from other sources provided that the LNG meets the prescribed quality specifications, the seller may take into account various factors when considering whether it is commercially proportionate to procure replacement supplies. Such factors may include, but are not limited to:

- The availability of alternative supplies in the market and/or its wider portfolio. Here the scale of the shortfall is impactful: is it a full missed cargo or rather a partial cargo?
- The price of sourcing LNG from an alternative supply versus the applicable contract price.
- Shipping availability and the cost impact of shipping a replacement cargo from another load port, which may be geographically much further away than the original load port.
- Scheduling constraints, such as whether the seller has existing arrangements in place with other counterparties and whether delivery windows are available. Moreover, it may be necessary to consider how feasible it is to redeliver in the current contract year (with contractual rateability and profile constraints) or whether the allocation of replacement volumes is only possible in subsequent years; a point which may (again) be impacted by the contract's rescheduling, makeup and annual programming wording.
- The impact of any club or allocation rules in the relevant agreement to allocate supply on an equitable basis among long-term and short-term customers.

It is important to note, however, that the mitigation efforts will be measured against the endeavours obligation stipulated in the relevant provision. For example, in circumstances where the seller must use reasonable endeavours to overcome the *force majeure*, it is unlikely that the seller would be required to subvert its own commercial interests in purchasing higher-priced cargoes at greater shipping cost. This is an important point to weigh up for long-term buyers in their appraisal of the issue and how hard they press sellers for replacement supply. Times like the present may call for a commercially sensible approach, with one eye firmly placed on the long-term relationship and the resumption of supplies in due course. That being said, buyers should remain vigilant and use vessel tracking data where applicable, to determine any patterns in seller responses and whether sellers are redirecting cargoes to higher-value markets while claiming that no supplies are available.

## The Trading Desk Response

The discussion above largely focuses on the high-volume long-term exposure to the issues in the Middle East. However, a considerable percentage of impacted volumes in the Middle East relate to impacted short-term and spot-traded cargoes. In this regard, what are the key legal and commercial considerations in managing and mitigating the impact of those cargo shortfalls?

As one would expect, various factors apply here: the relevant contractual terms and conditions; a trading desk's optimisation strategy prior to delivery; the applicable risk appetite; metrics and parameters; and the existing hedging strategies and market liquidity.

Here, the contractual analysis is typically multifaceted: first, undertaking an assessment of the relevant MSA and confirmation notice with the seller to determine the scope, meaning and effect of the *force majeure* provisions and the duty to mitigate, the extent of the take or pay obligation, and any provisions on delayed or rescheduled delivery; and second, where there is a firm obligation downstream, undertaking a similar legal analysis to determine potential exposure, timings, relief and any possible liability.

As part of this exercise, certain time-sensitive and commercial risk options may need consideration regarding how best to handle the impacted cargo or strip. While the trader's handling of the issues will of course be impacted by the applicable facts, contracts and commercial relationship(s), responsive options in this market may include:

- Determining if cargo swaps are available and on what terms.
- Purchasing replacement spot cargoes from the market. This may be impacted by the firmness of the seller's duty to mitigate, the firmness of the applicable downstream commitment and the relevant market price for a spot cargo relative to the contract price, which may involve a significant delta.
- Taking steps to absorb the impact of the shortfall in the trading book, and absorbing or hedging the risk. This approach may be impacted by the existing scope, scale, and optionality within the trader's portfolio, specifically its ability to purchase other sources of supply or even other forms of energy and the nature of the downstream demand profile the business is managing.

It bears emphasising that the applicable risk profile is a key consideration here. One trading desk might have a greater appetite for risk than another, which might allow it to take actions that differ from another trading desk with a different risk appetite and portfolio. It follows that risk metrics vary, and in a highly volatile market like the present, a one-to-two-cargo exposure that has not been replaced or adequately hedged may impact risk-tolerance parameters quite quickly, exhausting the available risk bandwidth.

The relevant "contract versus market price" dynamic is also critical. Where a cargo shortfall occurs and spot prices rise significantly – due to an event in the market akin to the Middle East crisis – the decision to buy a replacement cargo may have massive financial consequences, not least due to the increase in the cost of acquisition but also based on the potential delta on the onward sale that could put the trading desk out of the money and again, swallow a large percentage of the risk-tolerance parameters.

These points are all very closely linked to the core subject matter of this article: what is the extent of the duty to mitigate, and does it extend to a duty to replace the missed cargo?

If the seller, who has declared *force majeure*, has a firm duty to mitigate under the applicable contract, the trader will ultimately receive a replacement cargo at the contract price. However, if there is uncertainty over supply and pricing dynamics in the months ahead and/or if a replacement cargo is ultimately not forthcoming (or not forecast to be forthcoming), this will play an important role on legal and commercial decision making. Put another way, the likelihood of receiving a replacement cargo, through the mitigation efforts, will impact how a trader books the deal in the portfolio and how the risk is managed.

The certainty around a seller's duty to mitigate is therefore vital. It may also have an impact on the portfolio P&L, and how a trading department addresses the shortfall in the short-term. This, for example, may include any new managerial permissions and authorities that the trading team may need, such as consent for new products or adjustments in the scale of existing products and other financial options.

In the current market, for many trading desks, a combination of responses are being deployed: (i) acquiring replacement volumes for the firm downstream obligations; (ii) absorbing the impact of the shortfall(s) where possible within the applicable book; and (iii) commencing the groundwork for contractual claims to recover losses suffered in the months ahead. These steps will all be impacted by the overarching analysis of the seller's duty to mitigate, the paper trail of correspondence that starts now and the contractual analysis that may help examine and determine the scope of the seller's duty.

If you have any questions on the subject matter of this piece, please contact the author.



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